Report of the Committee on Tax Developments

I. Introduction

As with the past year, 1989 was a year of adjustments and extensions of prior law rather than a year of new legislative initiatives or landmark court rulings. Several legislative proposals favorable to energy firms were introduced, but few were enacted in the major tax bill, the Revenue Reconciliation Act of 1989 (1989 Act).[1] The Bush proposal to restore reduced tax rates on capital gains produced several counter-proposals but was ultimately eliminated from the 1989 Act. Congress implemented a tax to finance the Oil Spill Liability Trust Fund put in place by the Tax Reform Act of 1986 (TRA).[2] The Internal Revenue Service (Service or IRS) released proposed regulations further defining mixtures eligible for the alcohol fuel income tax credit, while making further refinements through notices and announcements. Of note was the Supreme Court's ruling that utility customers' deposits were excludable from income of the utility.

II. Developments Affecting the Oil, Gas, and Coal Industries

A. *Deductions and Exclusions*

1. Energy Credit

a. Legislative Developments: Extension of Energy Credit

The 1989 Act extended the expiration date of the energy credit allowable for solar energy, geothermal, and ocean thermal property from December 31, 1989, to September 30, 1990.[3] Credit percentages and other associated provisions were unchanged.

b. Cases

In *Levin Metals Corp. and Subsidiaries v. Commissioner*,[4] the Tax Court held that transportation equipment used by a recycling business in transporting scrap metal and other solid wastes between collection sites and recycling plants and within and between recycling plants was not eligible for the energy credit. The Tax Court relied on the distinction in the legislative history between transportation equipment integrally related to the recycling process and transportation equipment used to transfer waste between geographically separate sites.

In a separate yet related area, the Service determined that transportation equipment used to haul solid waste to a disposal facility qualified as equipment

1. Pub. L. No. 101-239, 103 Stat. 2301 (1989).
2. Pub. L. No. 99-514, 100 Stat. 2085 (1986).
3. Pub. L. No. 101-239, § 7106, 103 Stat. 2301, 2306 (1989).
4. 92 T.C. 307 (1989).

used in the collection of solid waste for purposes of tax-exempt financing.[5]

c. Rulings—Energy Credit

The IRS clarified definitions in the energy tax credit area in several rulings. In Private Letter Ruling 89-44-030,[6] the Service held that the energy credit was available for rehabilitation expenditures for significant enlargement of an existing dam so long as the enlargement did not create significant adverse environmental effects. In this case, the Federal Energy Regulatory Commission had found that the project would not have significant adverse environmental effects. Further, the fact that the project included enlargement expenses in addition to rehabilitation expenses did not prevent an energy credit from being taken for the costs properly characterized as dam rehabilitation expenses.

Equipment that is qualified solar energy property constructed in 1989 is eligible for the energy credit even if not placed in service until after December 31, 1989. In Private Letter Ruling 89-46-076,[7] the Service determined that property of this type fell within the Technical and Miscellaneous Revenue Act of 1988 (TAMRA) amendment[8] for solar energy property because the property was constructed within the designated time period.

The Service examined the effect on the energy credit of subsequent developments in two private letter rulings. In Private Letter Ruling 89-51-013,[9] the Service ruled that second stage construction, for which no energy credit was claimed, would not impair the energy credit claimed on the original project. The Service noted that the second stage would not increase the installed capacity of the project above 25 megawatts and would divert water but would not create an impoundment of water. The ruling relied on a colloquy related to the extension of expiring energy credits enacted by TAMRA[10].

In Private Letter Ruling 89-42-019,[11] the Service held that investor-owners of turbines would not be subject to recapture of the energy credit where the owners granted an option to the operating corporation to acquire the turbines as part of a Chapter 11 bankruptcy reorganization plan. The granting of an option would not be deemed a disposition of the property until the corporation exercised its option, at which time the owners would then be subject to recapture.

In Private Letter Ruling 89-09-003,[12] the Service ruled that capitalized

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5. Priv. Ltr. Rul. 90-02-049 (Oct. 18, 1989).
6. Priv. Ltr. Rul. 89-44-030 (Aug. 7, 1989).
7. Priv. Ltr. Rul. 89-46-076 (Aug. 24, 1989).
8. Pub. L. No. 100-647, § 4006, 102 Stat. 3342 (1988).
9. Priv. Ltr. Rul. 89-51-013 (Sept. 20, 1989).
10. *See* 113 CONG. REC. S15455 (daily ed. Oct. 11, 1988) (colloquy between Sens. McClure, Baucus, and Packwood).
11. Priv. Ltr. Rul. 89-42-019 (Aug. 31, 1989).
12. Priv. Ltr. Rul. 89-09-003 (Nov. 22, 1988).

expenditures incurred to repair and modify boilers burning natural gas so that they could be fueled by either natural gas or coal would constitute new section 38 property for purposes of the investment tax credit. The expenditures were not eligible for the energy credit, however, because the repairs were in the nature of extending the life of petroleum-fired boilers rather than retiring them as was the intent of Congress when it enacted the energy credit.

In one placed in service ruling,[13] the Service held that a public utility was not entitled to either an investment credit or a depreciation deduction because a nuclear power plant met only two of the four factors indicating when a unit was considered placed in service. In determining that the plant had not been synchronized, the Service cited a utility news release stating that the synchronization test that had been performed was one of the final tests to ready the plant for commercial operations. But it was only a test. Actual synchronization had not occurred. In addition, the Service found that the utility did not have the necessary permits and licenses because a 5% power license was viewed by the Nuclear Regulatory Commission as part of a test program and was not at a level commensurate with the plant's specifically assigned function.

2. Nonconventional Fuels Credit—Code Section 29

a. Legislative Developments

The 1989 tax bill reported out of the Senate Committee on Finance would have extended by two years the production credit for nonconventional fuels, thus making the credit available for wells drilled or facilities placed in service before January 1, 1993.[14] In addition, the Senate would have made production of gas from a tight sands formation eligible for the credit even though the price of natural gas was no longer subject to price controls. Although the nonconventional fuel credit extension was not included in the final version of the bill, a colloquy between Senators Simpson and Bentsen indicated that the extension will be brought before the Senate Finance Committee in 1990.[15]

b. Rulings

The IRS issued two private letter rulings interpreting definitions of nonconventional fuels. In Private Letter Ruling 89-34-067,[16] the Service ruled that the nonconventional fuel credit could be claimed for the period prior to determination that certain wells were tight formation wells under section 503 of the Natural Gas [Policy] Act (NGPA).[17] The Service reasoned that the

13. Priv. Ltr. Rul. 89-42-002 (June 21, 1989).

14. SENATE COMM. ON FINANCE, 101ST CONG., 1ST SESS., EXPLANATION OF PROVISIONS APPROVED 16 (Comm. Print 1989).

15. 135 CONG. REC. S16657-58 (daily ed. Nov. 21, 1989).

16. Priv. Ltr. Rul. 89-34-067 (June 1, 1989).

17. 15 U.S.C. § 3413 (1988).

particular formation had historically been a tight formation. Later governmental determination was merely formal recognition of this fact.

In Private Letter Ruling 89-40-004,[18] the Service ruled that the proper definition of "tar sand" for purposes of the nonconventional fuels credit is the Federal Energy Agency administrative ruling definition in existence when the Crude Oil Windfall Profit Tax Act of 1980 (COWPA)[19] was enacted[20]. The Service rejected the definition adopted by the Department of Energy in December, 1980, because Congress could not have relied on that definition when enacting the credit provision.

In Private Letter Ruling 89-42-068,[21] the Service determined that the term "drilled" for purposes of applying section 29 to a coal seam refers to the "spudding in date," defined as the commencement of continuous drilling to the objective depth. The Service rejected a "placed in service" concept as the qualifying date. Such a concept would have required placing the well in a more completed state for production. The Service also ruled that, where a partnership acquires a working interest in a well or other property, the partnership is the taxpayer for purposes of the credit, and each person who is a partner at the time the qualified fuel is sold will be allocated the section 29 credit with respect to his or her distributive share of partnership income regardless of whether the person owned an interest in the partnership at the time of production.[22]

In Private Letter Ruling 89-50-026,[23] the Service defined what property was eligible for the credit as "new production." The Service determined that the NGPA definition of a "proration unit" of a reservoir was a more appropriate definition than the definition of property under section 614(a) of the code. The Service reasoned that this unit would not preclude a subsidy for the efficient development of a particular portion of a reservoir that had been tapped in some other portion prior to 1980.

3. Alcohol Fuel Income Tax Credit—Code Section 40

a. Regulations

Under proposed regulations,[24] a product will be considered a "mixture" of alcohol and gasoline or of alcohol and a special fuel if the product is derived from alcohol and either gasoline or a special fuel. This will be true even if the alcohol is no longer present as a separate chemical in the final product, provided there is no significant loss in the energy content of the alcohol. The regulations were in response to use of ethyl tertiary butyl ether (ETBE) as an

18. Priv. Ltr. Rul. 89-40-004 (June 20, 1989).
19. Pub. L. No. 96-223, 94 Stat. 229 (1980).
20. FEA Rul. 1976-4, 41 Fed. Reg. 25,886 (1976).
21. Priv. Ltr. Rul. 89-42-068 (July 26, 1989).
22. *Id.*; *see also* Priv. Ltr. Rul. 89-15-019 (Jan. 10, 1989).
23. Priv. Ltr. Rul. 89-50-026 (Sept. 18, 1989).
24. 54 Fed. Reg. 48639 (1989).

octane enhancer, but the regulations are broad enough to encompass other mixtures. The proposed regulations would be effective as if enacted with the original provisions.

4. Depreciation

a. Rulings

The Service ruled that an anthracite culm burning cogeneration facility would qualify as a waste reduction and resource recovery plant for purposes of determining depreciation deductions.[25] The anthracite culm resulted from the initial process of separating noncombustible material from marketable anthracite. The culm was to be burned with silt derived from a coal washing process that further separated marketable anthracite from waste. The culm and silt had historically been impounded on land adjacent to the coal mine. The Service determined that the culm and silt were "solid waste" under regulations promulgated pursuant to section 103 of the code and that the use of oil and coal as start-up fuel did not prevent the facility from qualifying as a waste reduction and resource recovery plant.

The Service continued to define the placed in service date for purposes of the depreciation deduction, although the rulings are also relevant for other purposes, including eligibility for the energy credit. In Private Letter Ruling 89-09-043,[26] the Service ruled on the proper placed in service date of a power and lime-producing plant. The lime portion of the facility would be a physical component of the boiler and would function as a pollution control device with respect to the power facility in addition to producing saleable lime. Because neither the power nor the lime-producing components of the facility could function individually in the manner in which they were designed to operate, the Service, relying on *Hawaiian Independent Refinery, Inc. v. United States*,[27] ruled that the facility was a single property. Therefore, the facility would not be considered placed in service until both components were placed in service for purposes of the transitional rules in the TRA for investment tax credit and accelerated depreciation.

In Private Letter Ruling 89-24-010,[28] the Service determined the placed in service date for the conversion of a utility plant that was abandoned after 12 years of construction before being placed in service. The plant will be converted to a cogeneration facility that will produce electricity and steam. The facts of the ruling state that with fewer than two-thirds of the gas turbines functioning the facility may only be able to produce enough process steam to satisfy its contractual obligation to a manufacturing plant and enough electric-

25. Priv. Ltr. Rul. 89-24-032 (Mar. 17, 1989).

26. Priv. Ltr. Rul. 89-09-043 (Dec. 7, 1988).

27. 82-1 U.S. Tax Cas. (CCH) ¶ 9183 (Ct. Cl. 1982), *aff'd*, 697 F.2d 1063 (9th Cir. 1983), *cert. denied*, 464 U.S. 816 (1983).

28. Priv. Ltr. Rul. 89-24-010 (Mar. 10, 1989).

ity to satisfy initial contractual obligations to the utility. The Service ruled that the proper placed in service date would be when two-thirds of the gas turbines were functioning and the facility would be able to operate regularly in an integrated manner and at a level to receive the full contract price for the electricity and steam produced by the facility. The remaining turbines will be considered placed in service as each turbine becomes operational.

In Private Letter Ruling 89-22-008,[29] the Service examined the sale-leaseback of public utility property to determine treatment of unamortized accumulated deferred investment tax credits and unamortized deferred tax reserves resulting from accelerated depreciation. The Service concluded that, unlike the situation when public utility property is sold outright, the utilities and their ratepayers would continue to bear the cost of the property over the lease term, with regulated depreciation expense being replaced by a regulated rental expense. The Service held that the utility could ratably amortize the unamortized investment credits over a period no shorter than the lease term to reduce cost of service for ratemaking purposes and on its regulated books of account.

5. Depletion Deduction

a. Legislative Developments

Several Senators introduced Senate Bill 828, the Enhanced Oil and Gas Recovery Act of 1989, which would provide tax incentives for the removal of crude oil and gas through enhanced recovery techniques.[30] The tax incentives fall into four categories: (1) an increase in the percentage depletion rate for domestic oil and gas recovered through enhanced recovery techniques to 27.5%, phased-down as the price of crude oil increases above $30 per barrel adjusted for inflation; (2) an increase in the net income limitation on this oil and gas from 50% to 100%; (3) the inapplicability of the alternative minimum tax preferences for percentage depletion and intangible drilling and development costs (IDCs) to the deductions attributable to this oil and gas; and (4) a 10% research and development tax credit on research to discover or improve tertiary recovery methods.

Hearings on Senate Bill 828 were held before the Senate Finance Subcommittee on Energy and Agriculture on August 3, 1989. At the hearing, Treasury advocated the President's proposal which would: (1) replace the 50% net income limitation with a limitation based on 100% of net income in the case of all percentage depletion allowable under the Code; (2) allow percentage depletion to be claimed by a transferee of proven oil or gas producing property; (3) eliminate 80% of the present law preference attributable to IDCs incurred by independent producers for exploratory drilling; and (4) provide a 10% tax credit for certain projects utilizing tertiary enhanced recovery

29. Priv. Ltr. Rul. 89-22-008 (Feb. 27, 1989).

30. S. 828, 101st Cong., 1st Sess., 135 CONG. REC. S4181-83 (daily ed. Apr. 18, 1989).

techniques.[31]

The 1989 tax bill reported out of the Senate Finance Committee included a provision that would have eliminated the net income limitation percentage depletion deductions on marginal domestic oil and gas production.[32] The term "marginal production" would have generally included (1) domestic crude oil and natural gas produced from stripper wells and (2) domestic crude oil that is "heavy" oil.[33] The provision was not included in the final version of the 1989 Act.

b. Rulings

In Private Letter Ruling 89-37-033,[34] the Service held that the small producer depletion allowance would continue to be available to partners following distribution of the partners' interests in oil-producing property and subsequent contribution of the interests by participating partners to a new corporation. Although the depletion allowance is not available to a transferee of any interest in a proven oil or gas property transferred after December 3, 1974, the Service did not deem the partners in this transaction to be transferees to the extent that they were entitled to a percentage depletion with respect to the proven property before the transaction. The Service reasoned that the partners would merely be receiving their proportionate share of partnership property in respect of which they, as partners, were qualified to claim percentage depletion deductions prior to the distribution. Similarly, contribution of interests to the new corporation would not affect the deduction to the extent partners were entitled to a deduction immediately prior to the contribution.

In Private Letter Ruling 89-41-002,[35] the Service ruled that a nonrecourse loan secured by a corporation's overriding royalty interest in oil and gas properties was not in substance economically equivalent to a production payment. The mineral interest involved was not an economic interest in mineral in place because the interest was not solely satisfied from the production of minerals from the burdened interest, but could also be satisfied by proceeds of the sale of the overriding royalty interest.

B. Mineral Interests and Royalties

1. Cases

Based on pre-1986 law, the Tax Court held in *Louisiana Land and Exploration Co. and Subsidiaries v. Commissioner*[36] and *Houston Oil and Minerals*

31. Daily Report for Executives (BNA) No. 149 at L-1 (Aug. 4, 1989).

32. SENATE COMM. ON FINANCE, 101ST CONG., 1ST SESS., EXPLANATION OF PROVISIONS APPROVED 198 (Comm. Print 1989).

33. Heavy oil has a weighted average gravity of 20 degrees API or less corrected to 60 degrees Fahrenheit.

34. Priv. Ltr. Rul. 89-37-033 (June 20, 1989).

35. Priv. Ltr. Rul. 89-41-002 (June 16, 1989).

36. 92 T.C. 1340 (June 27, 1989).

Corp. v. Commissioner[37] that the transfer of an overriding royalty interest in productive oil and gas property did not trigger recapture of IDCs. The court determined that, under the risk analysis approach, the taxpayer retained a working interest in the oil and gas leases against which the IDCs were chargeable, while transferring only nonoperating mineral interests which were not "oil, gas or thermal property" for purposes of sections 1254 and 263. IDCs would be subject to recapture if disposed of in 1986 or later because, under the TRA, nonoperating mineral interests come within section 1254.

In *Yates v. Commissioner*,[38] the Tax Court ruled that cash payments received by taxpayers for their assignments of oil and gas leases were taxable as ordinary income subject to depletion rather than as long-term capital gains. The taxpayers had retained a limited interest in the lease properties that would terminate when 90% of the oil or gas had been produced in order to qualify the payments as production payments subject to capital gains treatment. The court concluded that the payments were overriding royalties because the term of the payments could be expected to be coterminous with the leases. The court determined that there was no real difference between the 90% standard and the entire term of the lease, given the speculative prospects for productivity on the leased land.

In *ZuHone v. Commissioner*,[39] the court of appeals held that overriding royalty interests received by the taxpayer for services in promoting and selling fractional working interests in oil and gas leases were includable in income as compensation for services. The taxpayer had argued that the royalty interests were not includable under the "pool of capital doctrine" applicable when services or property are contributed toward the acquisition, exploration, or development of oil and gas properties and an economic interest in the well is received in return. According to the court, under this doctrine, proceeds of the interest, subject to depletion, are taxable on receipt on the theory that it would be inequitable to tax the recipient on the speculative value of an economic interest in a pre-production mineral investment. While the court noted that this doctrine appeared to have fallen into disfavor with the Service and courts, it went on to hold that the taxpayer did not meet the six-factor test associated with the doctrine.

C. *Excise Taxes*

Notice 89-38[40] modifies certain provisions contained in Notice 88-132[41] relating to excise tax on diesel and aviation fuel. In addition, Notice 89-38 broadens the definition of "wholesale distributor" to include any person who holds himself out as selling fuel to farmers, fishermen, and other off-road users for nontaxable purposes.

Notice 89-101[42] states that a gasoline taxpayer may sell gasoline at the

37. 92 T.C. 1331 (June 27, 1989).
38. 92 T.C. 1215 (1989).
39. 883 F.2d 1317 (7th Cir. 1989).
40. I.R.S. Notice 89-38, 1989-1 C.B. 679.
41. I.R.S. Notice 88-132, 1988-2 C.B. 552.
42. I.R.S. Notice 89-101, 1989-2 C.B. 435.

reduced excise tax rate for gasohol production only to a registered gasohol blender who certifies that the gasoline will be used to produce gasohol within 24 hours after the sale. The provisions supplement the reduced-rate sales of gasoline where gasohol is produced at the time of the removal or sale and are effective October 1, 1989.

In Revenue Ruling 89-8,[43] the Service concluded that gasoline or diesel fuel purchased by a foreign diplomatic or consular official with a credit card issued by an oil company would not be subject to federal gasoline excise taxes. The amount of the tax should be deducted by the oil company's billing department.

The Service clarified that diesel fuel is any liquid that is commonly or commercially known or sold as a fuel suitable for use in a diesel-powered highway vehicle or diesel-powered train.[44] Aviation fuel was defined to include kerosene or any other liquid commonly or commercially known or sold as fuel suitable for use in an aircraft. Kerosene destined for use as heating oil is exempt from the tax. Special rules apply when kerosene is used as an additive to thin diesel fuel in cold weather.

Notice 89-29[45] details procedures for filing the gasoline tax credit or refund in the case of a wholesale distributor who purchases gas at a price that includes the tax and sells the gasoline to an ultimate purchaser for an exempt purpose (i.e., to a state or local government or exempt organization or for use in the production of special fuels). Under amendments made by TAMRA, a gasoline wholesale distributor will be treated as the person who paid the gasoline tax for purposes of the credit or refund.

Notice 89-20[46] provides taxpayers with guidance on paying additional taxes and obtaining a credit for taxes paid pursuant to changes in the Leaking Underground Storage Tank (LUST) tax provisions contained in TAMRA. An amended form 720 must be filed for additional tax liability related to gasoline floor stocks, fuel used on inland waterways, and gasoline used in noncommercial aviation. Taxpayers may also file for credits for overpayment of taxes related to use of special motor fuels.

D. *Crude Oil Windfall Profit Tax*

1. Cases and Rulings Applicable to Pre-Repeal of Windfall Profit Tax

Although the Windfall Profit Tax (WPT) was repealed in 1988, the tax will continue to apply to oil removed or treated as removed before August 23, 1988. The courts and the IRS continue to interpret the provisions of this tax.

In *Amerada Hess Corp. v. Director*[47] the Supreme Court upheld the New Jersey Supreme Court ruling that net income, for purposes of the state corporation business tax, included the federal WPT on crude oil production. Each of thirteen major oil companies had deducted its federal WPT in calcu-

43. Rev. Rul. 89-8, 1989-1 C.B. 294.
44. I.R.S. Notice 89-17, 1989-1 C.B. 647.
45. I.R.S. Notice 89-29, 1989-1 C.B. 669.
46. I.R.S. Notice 89-20, 1989-1 C.B. 650.
47. 109 S. Ct. 1617 (1989).

lating "entire net income" for purposes of the state tax, which generally precludes deduction of a federal tax that is "on or measured by profits or income . . . ."[48] The Court rejected the oil companies' argument that the WPT was an exclusively out-of-state expense associated with production of oil outside the state, finding that, when a state denies a deduction for a cost of a unitary business, the resulting figure is still a unitary one. The Court found that the taxation based on the add-back of the WPT met the tests for fair apportionment and did not discriminate against interstate commerce.

In *Burton v. Commissioner*[49] the taxpayers relied on the Crude Oil Price Bulletin of West Texas Marketing Corporation in computing their liabilities for the WPT. The Tax Court held that the taxpayers did not prove that the bulletin established the highest posted price for purposes of the tax.

The Service disallowed an oil producer's state severance tax adjustment to the WPT that was calculated by first decreasing the state severance tax valuation amount by the WPT adjusted base price. In Private Letter Ruling 89-44-004,[50] the Service held that the severance tax adjustment is the difference between the amount of severance tax actually paid to the state and the amount of severance tax that would be imposed on each barrel of oil if it were valued at its adjusted base price.

In Notice 89-19,[51] the Service announced that, for purposes of the WPT, liquids recovered from natural gas steams are taxable crude oil only if such liquids are captured, saved, and sold in liquid form at atmospheric pressure (1) at or before the inlet side of a gas processing plant or (2) prior to the application of non-mechanical processes. The notice cites *UPG, Inc. v. Edwards*[52] where the Temporary Emergency Court of Appeals concluded that pipeline residue (drip condensate) separated by non-mechanical means of pipeline forces and extraction through drip and ball run tanks was crude oil. The phrase "inlet side of a gas processing plant" is not defined in the notice.

E. Oil Spill Liability Trust Fund

Several pieces of legislation were introduced to fund oil spill clean-up in response to the Exxon oil spill in Alaska. The 1989 Act contains a five cent per barrel petroleum tax to fund the Oil Spill Liability Trust Fund.[53] If the unobligated balance of the fund exceeds one billion dollars at the end of any calendar quarter, the tax rate will be zero. The tax will apply after January 1, 1990, and will remain in effect until December 31, 1994.[54] Senator Reid introduced a bill that would deny federal income tax deductions for the costs of cleaning up oil spills for taxpayers that do not make a good faith effort to

48. N.J. STAT. ANN. § 54:10A-4(k)(2)(C)(West 1986).

49. 58 T.C.M. (P-H) ¶ 89,041 (1989).

50. Priv. Ltr. Rul. 89-44-004 (Nov. 3, 1989).

51. I.R.S. Notice 89-19, 1989-1 C.B. 649.

52. 647 F.2d 147 (Temp. Emer. Ct. App. 1981).

53. I.R.C. §§ 4611, 9509 (1988), *as amended by* Revenue Reconciliation Act of 1989, Pub. L. No. 101-239, § 7505, 103 Stat. 2301, 2363-64 (1989).

54. Announcement 90-2, 1990-1 I.R.B. 62.

comply with federal clean-up standards.[55] Action has not yet been taken on this bill. Senator Stevens introduced a bill that would create a cleanup fund financed by a one cent per barrel tax on refined domestic and imported oil and that would reinstitute a five cent per barrel tax on oil transported through the trans-Alaskan pipeline to increase an existing fund established for cleaning up spills associated with the pipeline.[56]

III. Regulated Electric and Gas Utilities

A. *Customer Deposits*

The Supreme Court held in *Commissioner v. Indianapolis Power & Light Co.*[57] that deposits required from customers with suspect credit to assure prompt payment of future electric bills were not advance payments for services and thus did not have to be included in income when received. The Court found that the utility lacked requisite complete dominion over deposits at the time the deposit was made because the customer could get the deposit refunded in cash or could apply it to the purchase of electricity. The Court was particularly influenced by the fact that the customer could chose the form of repayment. Further, the utility had an express obligation to repay the deposit, either upon termination of service or at the time the customer established good credit. Therefore, the utility's right to retain the deposit was contingent upon events outside its control. Although discussing the analogy of the deposit to a loan, the Court did not focus on the fact that the utility paid interest on deposits held over a specified time.

B. *Normalization and Other Accounting Matters*

1. Legislative Developments

The House Ways and Means Committee defeated legislation that would have permitted public utility commissions to require utilities to reduce excess deferred tax reserves resulting from the TRA tax rate reductions either by a thirty-six-month amortization schedule or by the method provided under sections 167 and 168, whichever would be quicker.[58] Several Congressmen, including Representatives Dorgan and Matsui and Senator Wilson, introduced legislation[59] that would essentially allow state regulatory agencies, rather than the federal government, to determine when excess deferred taxes should be returned to customers in the form of lower utility rates. The Treasury Department opposed these bills, taking the position that shortening the normalization period would require utilities to seek more expensive financing and could lead

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55. S. 771, 101st Cong., 1st Sess., 135 Cong. Rec. S3909-10 (daily ed. Apr. 13, 1989).

56. S. 941, 101st Cong., 1st Sess., 135 Cong. Rec. S5001-04 (daily ed. May 9, 1989).

57. 110 S. Ct. 589 (1990).

58. Joint Committee on Taxation, Staff Descriptions (JSC-11-89) of Miscellaneous Tax Bills Scheduled for May 17, 1989, Senate Finance Committee Hearing, Released May 11, 1989.

59. H.R. 1150, 101st Cong., 1st Sess., 135 Cong. Rec. H468 (daily ed. Feb. 28, 1989); S. 1472, 101st Cong., 1st Sess., 135 Cong. Rec. S9762 (daily ed. Aug. 4, 1989).

to disruption of the capital markets.[60]

2. Regulations

In Notice 89-63,[61] the Service announced that it was developing regulations that will describe the extent, if any, to which adjustments and procedures that reduce a utility's ratemaking tax expense to reflect the tax losses of non-regulated affiliated companies will be treated as inconsistent with the normalization rules. Specifically, the Service indicated that the normalization requirements may be violated by reductions to total ratemaking expenses achieved through use of an "effective tax rate," by application of a "consolidated tax adjustment," or by other adjustments to utility costs of service leading to similar results. The regulations would apply to public utility rate orders that become "final determinations" on or after June 29, 1989.[62]

3. Rulings on Normalization

In Private Letter Ruling 89-03-080,[63] the Service held that a plan for phasing the costs of a nuclear plant to rate base would not violate normalization rules. Under the plan, ITC was currently amortized in rates only with respect to the percentage of plant that was in rate base. Book depreciation deductions that were deferred for ratemaking purposes earned carrying charges, and the Service found that, on a present value basis, the taxpayer's rates were equivalent to a one-time increase. Thus, computing deferred taxes based on the difference between tax depreciation and book depreciation was not violative.[64]

In Private Letter Ruling 89-04-008,[65] the Service ruled that a utility would not be in compliance with the normalization rules if it followed the state utility commission's proposal to add to deferred tax reserves that part of the total income tax liability paid by the utility to its parent. The tax liability in this case was not paid to the federal government currently because of non-regulated subsidiary losses that offset the taxable income of the utility in a consolidated return. Because neither the nonregulated losses nor any other aspect of the nonregulated operation was included as an item in calculating the utility's cost of service or rate base, the Service held that the proposed adjustment would achieve a rate base deduction not allowable under the normalization rules.

In Private Letter Ruling 89-10-012,[66] the Service held that section 3 of Revenue Procedure 88-12[67] provides guidance where a utility is unable to

60. Letter from Kenneth Gideon, Assistant Treasury Secretary for Tax Policy, to Rep. Raymond McGrath, Daily Report for Executives (BNA) No. 174 at G-3 (Sept. 11, 1989).

61. I.R.S. Notice 89-63, 1989-1 C.B. 720.

62. *See also* Priv. Ltr. Rul. 89-35-009 (May 26, 1989) (revoking Priv. Ltr. Rul. 87-11-050 (Dec. 15, 1986)); Priv. Ltr. Rul. 89-35-010 (May 26, 1989) (revoking Priv. Ltr. Rul. 86-43-052 (July 29, 1986)).

63. Priv. Ltr. Rul. 89-03-080 (Oct. 26, 1988).

64. *See also* Priv. Ltr. Rul. 89-45-047 (Aug. 16, 1989).

65. Priv. Ltr. Rul. 89-04-008 (Oct. 24, 1988).

66. Priv. Ltr. Rul. 89-10-012 (Dec. 6, 1988).

67. Rev. Proc. 88-12, 1988-1 C.B. 481.

make the comparison, required by the normalization rules, of the relative rapidity or size of the reduction in an excess tax reserve if the Average Rate Assumption Method (ARAM) has been applied rather than an alternative method. The Service allowed a utility to use the Reverse South Georgia Method (RSGM) for those years during which it had not maintained adequate records to make the required comparison.[68]

In Private Letter Ruling 89-20-025,[69] the Service ruled that, when equipment is transferred from a utility's regulated books of account to non-regulated books of account, the associated deferred taxes, including any excess deferred taxes, must be removed from the regulated books of account and must not be flowed through to ratepayers.

C. *Deductions and Exclusions*

1. Nuclear Plant Decommissioning Reserve Funds

Notice 89-16[70] provides guidance for companies that maintained internal reserves for nuclear decommissioning costs and that would not generally be able to qualify for a deduction for reserve fund payments under regulations issued last year pursuant to section 468. Those companies that did not specifically identify in rate orders the amount of decommissioning costs included in cost of service for ratemaking purposes, or that did not otherwise clearly indicate such amount in the written records of ratemaking procedures, may nonetheless qualify for the deduction if such costs can be accurately determined from information contained in either the regulated books of account or other written records of the company. These provisions apply, for any tax year ending on or before December 31, 1993, to companies that maintained an internal reserve prior to July 1, 1988.

2. Contribution in Aid of Construction—Code Section 118

a. Legislative Developments

The 1989 tax bill reported out of the Senate Finance Committee would have treated as Contribution in Aid of Construction (CIAC) the contribution by a governmental entity of money or other property that would be used predominantly in furnishing alternative water supplies for purposes of remedying environmental contamination or protecting the health of individuals threatened by environmental contamination.[71] This tax treatment would only apply if the contribution, or any property acquired or constructed with the contribution, was not included in the utility's rate base for ratemaking purposes. The provision was not included in the 1989 Act.

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68. *See also* Priv. Ltr. Rul. 89-22-015 (Feb. 28, 1989).

69. Priv. Ltr. Rul. 89-20-025 (May 19, 1989).

70. I.R.S. Notice 89-16, 1989-1 C.B. 647.

71. SENATE COMM. ON FINANCE, 101ST CONG., 1ST SESS., EXPLANATION OF PROVISIONS APPROVED 163-64 (Comm. Print 1989).

b. Rulings

In Private Letter Ruling 89-47-026,[72] the Service concluded that the 1986 amendments related to CIAC provisions did not apply where the purpose of the contribution could be analogized to cases of contribution by certain small power producers and cogenerators (Qualifying Facilities) to a utility to permit the sale of power by noncustomers, the Qualifying Facilities, to that utility. In this case, a natural gas supplier would reimburse a utility for a portion of the cost of constructing and operating a pipeline between the utility and the supplier in order for the utility to secure a long-term supplier. Relying on Notice 88-129,[73] the Service concluded that (1) the supplier did not transfer property as a customer, (2) the cost of the transferred property was not included in the utility's rate base, and (3) the utility would not earn a profit on the transferred property. Similarly, in Private Letter Rulings 89-13-009[74] and 89-14-008,[75] the Service ruled that neither payments of money nor transfers of property by a Qualified Facility to a utility for the purpose of constructing a connection to the utility's power system would be deemed CIACs. However, if the utility constructed the property in exchange for a payment from a Qualifying Facility pursuant to a PURPA contract, the utility would be deemed to construct the property for the Qualifying Facility under contract and would recognize income from the construction as under any construction contract.

In Private Letter Ruling 89-09-019,[76] the Service ruled that a lease of property owned by a nontaxable municipal corporation to a taxable utility created a taxable CIAC to the extent that the fair market value lease payments exceeded the actual lease payments. Although this ruling involved a water utility, the rationale would apply to gas and electric utilities as well. In Private Letter Ruling 89-10-025,[77] the Service held that a transfer of a water main by a town to a water utility constituted a taxable CIAC on the theory that the transfer was a prerequisite to service for the town's residents, and therefore, the town benefitted. This theory brought the transfer within the scope of Notice 87-82,[78] which requires, among other things, that the transfer be either by a customer or by someone deriving a benefit from the services provided as a result of the transfer. The Service did not address the question of whether the "benefit of the public as a whole was the primary motivating factor" in the transfer. As discussed at Notice 87-82, transfers falling within this "public benefit" rule are not taxable CIACs.

72. Priv. Ltr. Rul. 89-47-026 (Aug. 25, 1989).
73. I.R.S. Notice 88-129, 1988-2 C.B. 541.
74. Priv. Ltr. Rul. 89-13-009 (Dec. 23, 1988).
75. Priv. Ltr. Rul. 89-14-008 (Dec. 23, 1988).
76. Priv. Ltr. Rul. 89-09-019 (Dec. 2, 1988).
77. Priv. Ltr. Rul. 89-10-025 (Dec. 8, 1988).
78. I.R.S. Notice 87-82, 1987-2 C.B. 389.

3. Payments to Customers

In Private Letter Ruling 89-24-002,[79] the Service held that cash payments made to electric customers who installed energy saving equipment constituted income to the customers. The utility argued unsuccessfully that the payments were in the form of nontaxable rebates. However, the Service found that (1) the utility was not the manufacturer of, or a dealer in, the equipment, (2) the payments were not based on the cost of the equipment, and (3) there was no arms-length negotiation of the payment. Therefore, the Service found that the utility was, in effect, paying customers who were providing a service to the utility, i.e., reducing peak demand, at the utility's request.

IV. FORECAST FOR 1990

Congress and the administration may be able to come to some agreement on tax incentives for oil drilling and production similar to the proposals contained in Senate Bill 828. Sponsors of other legislative proposals not dealt with by Congress in 1989, such as the extension of the nonconventional fuels credit and changes to the normalization requirements, have indicated interest in reintroducing these proposals in the second session of the 101st Congress. The President has proposed in the 1991 budget a reduction in the capital gains rate that would benefit energy concerns.

Pamela A. Lacey, Chairman
Lee M. Goodwin, Vice Chairman

Leonard L. Coburn
Randall V. Griffin
Lindsay Johnson
James R. Lacey
Wallace F. Tillman

79. Priv. Ltr. Rul. 89-24-002 (Feb. 27, 1989).